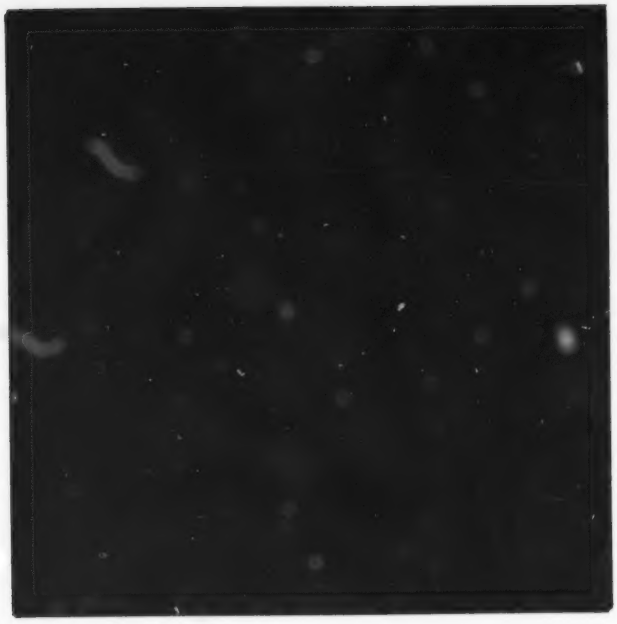

MINISTRY OF INDUSTRY,
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TECHNOLOGY
ONTARIO

SMALL BUSINESS ADVOCACY

REPORT NO. 29

AN EQUITY FINANCING VEHICLE FOR GROWTH COMPANIES

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EXECUTIVE SUMMARY

AN EQUITY FINANCING VEHICLE FOR GROWTH COMPANIES

Objectives

To support the growth of small and mid-sized firms by helping them gain more access to the equity capital needed to finance their expansion into strong, competitive enterprises.

To encourage venture capital investment and assist the development of the Ontario venture capital industry.

The Vehicle

Privately owned and operated pools of capital, regulated by the Ontario Government, invest in Ontario's growing businesses. The pools provide both capital and participative management expertise to the companies in which they invest.

The Incentive

Pools must raise a minimum of $5 million equity capital from their investors to qualify. Once a pool has invested 65% of its original equity in eligible growth companies, it can apply to borrow up to twice the amount of its equity by issuing debentures which are fully guaranteed by the Ontario Government. Debentures are sold to institutional investors, notably pension funds.

Investment Criteria

Pools may invest up to 20% of their capital in any single growth company. Each pool must provide equity capital and may provide long-term (5 to 20 year) loans or take back debt securities such as convertible debentures.

Pools may not take control positions in their portfolio companies, nor may they charge more on term loans than the interest rate set by regulation. In other respects, pools are free to negotiate with each individual business to create the deal that best serves the parties' interests.

Eligible Investments

The following are not qualified pool investments:

- companies with more than $20 million in annual sales;
- companies with more than 50% of their assets and operations outside Ontario;
- passive or casual businesses not engaged in regular and continuous business operation;
- companies engaged in real estate, financing or mining activities;
- companies connected to the pool or to its shareholders, directors, officers or employees;
- other venture capital pools.

All other businesses are eligible.

Matching services are available through the Canada Opportunities Investment Network (COIN) to assist pools and growth firms to find one another.

The Government's Role: Administrative

The Government of Ontario subjects the pool and its investors to a thorough scrutiny. A regulatory body, with private sector participation, conducts extensive background checks of the applicants and must approve the full-time manager - generally someone with a strong interest in aiding growing businesses and with a number of years of experience or combination of experience and training in business investing.

Pools are subject to annual reporting requirements and to yearly inspection. They also must submit audited financial statements yearly.

The Government's Role: Financial

The Government of Ontario fully guarantees the ten-year debentures issued by approved pools, up to a ceiling of $35 million per pool.

The debentures bear interest at a rate determined by the Treasurer of Ontario - equal to or slightly higher than the rate for ten-year government bonds.

Costs

The Government's liability for losses on debenture guarantees is estimated to be about 12% of the amount guaranteed. Annual administration costs are estimated at $1 million.

Benefits

Estimated take-up for the first twelve months of the program is $20 million invested in 15 small and mid-sized firms; by the fifth full year of the program up to $100 million annual new investment is expected.

Once the program is well-established (estimated five years from launch), a pool would manage perhaps $30 million in assets, divided amongst approximately 18 growth-oriented businesses in the following proportion:

- 8 firms in the investment range of $350,000 - $1 million;
- 6 firms in the investment range of $1 - $2 million;
- 4 firms in the investment range of $2 - $5 million.

. More small and young companies will be able to realize their growth potential.

. Thousands of new jobs will be created.

. The economy will be strengthened and better positioned to ride out cyclical downturns.

. Government revenues from income and commodity taxes will increase.

. Institutional funds, previously unavailable to small and mid-sized firms, will be accessed.

. A mature venture capital industry will be available to service the financing needs of dynamic businesses.

. A financial infrastructure, ready to compete in the post-free trade investment market, will be in place.

AN EQUITY FINANCING VEHICLE FOR GROWTH COMPANIES

I. INTRODUCTION

A. Financing Growing Companies

Canadian studies over a seven-year period have found that over 30% of net new jobs are created by less than 1% of firms - those small and medium-sized firms that grow into medium-sized and large firms. Approximately 1200 Ontario growth companies generated over 208,000 new jobs between 1978 and 1985 as they expanded beyond their original size category.[1] Small firm growth fuels job creation.

Growth may also be an effective survival strategy for small firms. U.S. research into newly-formed firms found a striking correlation between survival and growth. Firms which added jobs over eight years had survival rates ranging from 66% to 78%, with higher rates correlating to larger numbers of added jobs. In comparison, firms which failed to add any jobs within their first six years of life had an eight year failure rate as high as 73%.[2]

However, only a small percentage of Canadian companies grow from small to medium-sized, even though the Canadian business start rate is as high or higher than the U.S. rate.

There may be many reasons for the low growth rate of small Canadian companies: the smaller Canadian market; less sophisticated, less motivated or less skilled entrepre-

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[1]Twenty-nine small companies increased their net employment by an average 1,090 new jobs each as they grew into large firms. Another 1,040 small companies grew to medium size and created an average of 94 net new jobs each. One hundred sixty-seven medium-sized companies averaged a net increase of 479 new jobs as they became large.

Source: Statistics Canada, Business Microdata Integration and Analysis (unpublished).

[2]Source: Bruce D. Phillips, Small Business Survival and Growth: Macro and Micro Economic Perspectives, U.S. Small Business Administration, Office of Advocacy, September 1988.

neurs; perhaps even the structure of the Canadian corporate tax system, which has assisted larger firms to grow relatively faster than small and mid-sized ones. One known factor is low capitalization for start-up and refinancing.

A comparison of a sample of successful growing businesses with a cross-section of recently-started businesses reveals that the average initial investment in the growth companies was seventy-two times greater than the average initial investment in the cross-section. The growth companies' median initial investment was $425,000. Even without the biggest 20% (whose initial investments ranged from $6 to $15 million), the remaining growth companies' average initial investment was $350,000 - more than ten times the $30,000 average for the cross-section.

Virtually all of the successful companies sought subsequent funds for refinancing, and 94% of them refinanced with bank debt. This may be because these companies created a sufficient equity base to attract bank lenders: 35% reinvested their own capital in order to refinance. In contrast, only slightly more than half the cross-section felt they needed further financing. 41% of the cross-section secured refinancing, while 12% tried to do so and failed. Only 6% of this group reinvested their own funds to refinance.[3]

A survey of young companies conducted for the Premier's Council found that entrepreneurs identified raising capital as the most serious challenge facing start-up companies. Lack of equity capital was identified as a constraint to growth by 74% of the firms interviewed and lack of debt capital at an affordable cost by 59% of the firms.[4]

B. **The Need for an Equity Financing Incentive**

Many factors lead businesses to prefer to finance their

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[3]Source: Ontario's Successful Businesses, research study conducted for the Ministry of Industry, Trade and Technology by Decision Marketing Research Ltd., 1987.

[4]Source: Competing in the New Global Economy, Report of the Premier's Council, vol. 1, citing results of survey conducted on behalf of the Premier's Council by the Canada Consulting Group and Telesis.

operations and expansion with debt rather than equity. Except in times of tight credit and high interest rates, debt is generally cheaper, dollar for dollar, than equity. Interest payments can be deducted in full from the business's income, thus lowering taxes and increasing profitability, and the business owner still retains complete control of the operation.

Studies have shown that average debt-to-equity ratio for smaller firms is 55:45, compared to 41:59 for firms with assets greater than $25 million.[5] In addition, a new study of Ontario manufacturing companies indicates that companies with $2 - $25 million annual sales are more highly levered than either smaller (under $2 million) or larger (over $25 million) companies, though smaller companies are still more highly levered than the weighted average.[6]

When times are good, businesses can sustain higher levels of debt. However, the last recession showed the painful results of unbalanced debt-equity ratios in smaller companies. As interest rates rose, some small firms lost the ability to service their debt loads. Many were caught in a cash flow squeeze, and their businesses failed. The availability of lower-cost equity financing may be the key to "recession-proofing" the small business sector.

Equity financing for growing businesses tends to be expensive because of the increased riskiness of these business ventures: they tend to be younger, with less of a track record; they may be slimly capitalized and thus vulnerable to changes in the economic climate. Providers of equity capital to small and mid-sized firms demand a higher return to compensate them for the greater risk - often a return higher than the business owner is willing to pay.

The need is thus for lower-cost equity financing. Return on equity can be lowered by lowering the risk. Although the inherent riskiness of growth firm investment cannot be modified, the effective risk can be reduced by pooling - sharing the risk of a number of companies over a number of investors - and by levering one's own risk capital with

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[5]Source: Economic Council of Canada, based on unpublished data from Statistics Canada.

[6]Source: Ontario Development Corporation, April 1988.

funds borrowed at a moderate interest rate.

Supplying equity capital for growth firms has traditionally been the purview of venture capitalists. However, the Ontario and Canadian venture capital industry has moved away from early-stage investments and is not acting as an effective intermediary between large institutional sources of capital and growing companies. Nor is it as developed as the American industry: in 1986, for example, the state of Massachusetts had venture capital assets of $525 per capita, while New York and California had approximately $300 per capita. Ontario had $81 per capita.[7]

It is interesting to compare the structures of the U.S. and Canadian venture capital industries. The industry is made up of three separate groups of firms: private independent venture firms; venture subsidiaries of financial and non-financial corporations; and government-sponsored or related groups. In the United States, over 75% of industry capital is now managed by private independent venture firms. However, in the late 1970's, only about 40% was so managed - equivalent to the 41% of the Canadian industry's capital under management by independent firms in 1986.[8]

As the Premier's Council Report points out, investing in growing companies is really investing in the entrepreneur and his or her potential. The key to successful venture investing in growing companies is for the investor to take a participative, rather than passive, role and assist the entrepreneur in the general management of the company.

The Council's research found that participative venture capital funds are very rare in Ontario. The problem is thus not so much a shortage of venture funds as it is a shortage of knowledgeable participative financiers.[9]

There is room for an Ontario initiative which employs pooling and levering to reduce effective risk, in a program aimed at fostering growth and expertise in the venture

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[7]Source: Venture Economics Canada.

[8]Source: Venture Capital in Canada: An Overview, Venture Economics Canada Limited, November 1987.

[9]Source: Competing in the New Global Economy, Report of the Premier's Council, vol. 1.

capital industry to create a financial infrastructure that supports the business growth of the future.

C. **A Caveat**

The reluctance of business owners to take on outside equity investors may be one reason for the perennial complaint from venture capitalists that there is "plenty of money, but no deals". Another reason may be a scarcity of good prospects - growing companies with good management, a market niche, and the potential for outstanding growth.

If there is a paucity of good prospects, an equity financing initiative will not remedy it. An equity financing program is not a panacea. It fertilizes the soil of the province so that the business seeds sown by entrepreneurs may grow and flourish; it does not create the seeds.

An equity financing program is not a substitute for management skills training, awareness, or entrepreneurial education. However, other initiatives of the Small Business and Entrepreneurship Branch of the Ministry of Industry, Trade and Technology, such as management skills training seminars and publications, self-help centres for entrepreneurs, and entrepreneurial education programs in Ontario schools and colleges, may assist entrepreneurs to improve their skills and increase their attractiveness to outside investors.

II. FEATURES OF AN EQUITY FINANCING VEHICLE

Design Features:

- **Breadth.** The program should be open to all growing businesses. The market should decide which sectors of the economy to support.

- **Ontario-directed.** The program should assist Ontario businesses. In principle, there is no reason to exclude investment money coming from non-residents, especially in light of the free trade agreement.

- **Control.** The need for limiting the maximum equity position a pool or group of pools can take in a business should be assessed. It may be preferable to leave the parties free to negotiate their own deal, trusting that the business owner's desire to retain control and the fund's preference for investment over day-to-day management will be sufficient safeguards.

- **Incentives.** The incentive scheme should provide sufficient dilution of the riskiness of growth firm investments without attracting investors for tax rather than investment reasons.

- **Tax treatment of proceeds.** This is a sister issue to incentives. Special capital gains treatment for investments in small business is available under the federal rules to investors who can fit within the rules.

- **Abuse prevention.** The program should incorporate measures designed to curb abuse. Options include: screening, importing a due diligence scrutiny; arms'-length requirements; a conflicts provision (full disclosure by investors of their business interests and holdings); apportioning liability for fraudulent or negligent misrepresentations; limits on firm use of funds (no relending to pool principals or investors).

- **Improved reporting and feedback.** The program should have a simple, non-burdensome system of monitoring results. Computer support should be used wherever possible to collect data about success and failure rates, jobs created and resulting changes to tax revenues.

- **Networking.** The program should include a matching service to enable businesses seeking capital, investment pools seeking both funds to invest and investment opportunities, and investors seeking an investment pool

to find one another. This service could also function as a connection point to financial intermediaries and investment professionals for deal-structuring.

- **Awareness.** The design should educate the public about the risks and returns of venture investing.

Design Criteria:

- **Increased financial sophistication.** The program should facilitate the formation of larger, better-developed pools of capital for investment in growing firms, and the development of the expertise required to successfully manage such pools.

- **Flexibility and functionality.** The program should be conceived of as a nursery to grow companies. Additional rounds of financing should not be precluded. The program should support financing structures which the investment community is familiar with and wants to use (limited partnerships, syndications), without foreclosing future financing innovations.

- **Simplicity.** The program should be easy to understand and use. It should be apparent to investors, legal and accounting advisors, fund managers, provincial administrators, and growth firms if an investment is offside.

- **Private-sector driven.** In principle, financing decisions should be left up to the private-sector investors, although an anti-abuse mechanism (such as a percentage of total assets ceiling for any one investment, similar to the U.S. SBIC rules) may be needed.

- **Liquidity.** Exit opportunities, for both the vehicle's investors and the vehicle itself in realizing its investments, must be considered.

- **Administration.** The program, and especially the incentives for investment, should be cost-effective, knowable, cappable, and simple to administer.

III. OPTIONS

The investment pools program has emerged as the preferred strategy upon consideration of three major alternatives.

A. Ontario Stock Savings Plan

The Ontario Stock Savings Plan is an option based on initiatives in several other provinces, notably Quebec. The plan gives investors who buy shares in specified provincially-based publicly-traded companies a tax deduction of up to 100% of the amount invested (or equivalent tax credit).

Pro

- private-sector decision-making
- accessible to most investors
- simple to understand and use

Con

- benefits larger companies making public share offerings
- costs are difficult to forecast and control; may be high
- using regressive tax system incentives is contrary to direction of tax reform
- creates no investment pools for growing firms

B. Small Business Development Corporations Program

Another option is to revitalize the Small Business Development Corporations (SBDC) program, currently administered by the Ministry of Revenue. This program offers tax-free cash grants or tax credits to investors in eligible small businesses.

Although the incentive is a generous 25% of investment (30% in the north and east), use of the program has been dwindling of late. In the 1987-88 fiscal year, SBDC registrations ran at a net loss - 102 revoked or withdrawn SBDCs as against only 91 total registrations. Net incentives approved for the fiscal year amounted to only $9.3 million. In

the 1988-89 fiscal year to December 31, 1988 (9 months), net registrations, while positive, stand at only 15, and net approved incentives amount to less than $3 million.

Revitalizing the program could involve a complete overhaul of its rules, promotion and administration, including:

1. eliminating the tax credit as an incentive, as it is unpopular and creates extra administrative costs;

2. allowing grants to be paid to SBDC investors which are limited partnerships with a corporate general partner;

3. raising the existing $2.5 million cap on investment in any single small business to $5 million;

4. expanding (or removing) the existing $10 million capitalization cap for publicly-owned SBDCs, to permit economies of scale and enhance listability, tradeability, and the attractiveness of the investment;

5. banning public SBDCs altogether, as

   a) they tend to be managed by a professional management group which may not have its own funds at risk in the small enterprises,

   b) the individual "at risk" investors may be unsophisticated and unaware of SBDC program requirements,

   c) an SBDC investment going offside could result in grant recovery efforts affecting thousands of innocent investors, and

   d) public SBDCs may encourage tiering, the practice of issuing multiple classes of shares in order to allocate investment targets to the holders of particular share classes. Tiering supports investors' attempts to bypass the arms'-length rules and creates recovery difficulties when one investment goes offside and all the SBDC shareholders of whatever class are liable to repay their grants.

It is unclear whether revamping the program will attract more investment dollars. The decline of SBDCs in recent years may be a symptom of some facet in the business environment unresponsive to government programming. According to investors, the unworkable elements of the program are

the sectoral and geographical eligibility requirements, the scrutiny and approval of each aspect of each deal by the government, and the fact that the type of investor attracted by the incentive is more interested in a "freebie" or tax shelter than in the longer term rewards of investing in a growing business.[10]

Pro

- provides visible direct government assistance
- costs controllable
- eligibility expandable to all industry sectors

Con

- prone to abuse
- to control abuse, all aspects of transaction require minute scrutiny by government officials
- costly and complex administration
- uses direct government funds
- government intimately involved in business and financial decision-making
- no support from financing community
- likely to continue pattern of one-shot financings

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[10]See also the Premier's Council Report, 179:

> [T]he [SBDC] program precludes investment in high growth firms which require substantial capital and, if successful, will soon outgrow the SBDC's size requirement. Venture capitalists do not consider participating in the program because of regulations that ... restrict their investment decisions. Most ... SBDCs are actually small business investment vehicles set up by lawyers... .

C. **Small Business Investment Company Program**

The U.S. Small Business Investment Company (SBIC) program, a system of government guarantees for private investment pools, has operated successfully for thirty years. The program offers investors in small businesses the opportunity to lever their venture capital with government-guaranteed debentures. Currently, about 9% of total U.S. venture capital is invested through SBICs.

Since 1958, SBICs have provided over $7 billion in venture capital to approximately 85,000 small businesses. On average, these SBIC-financed small businesses have generated more than ten times the employment growth of other small firms, and have equally outpaced the growth of non-SBIC-financed firms in sales, pre-tax profits, and assets.

The following are examples of companies that received SBIC financing:[11]

	At SBIC Financing			Last Available Data	
	Year	Sales ($000)	Employees	Sales ($000)	Employees
Intel Corp.	1969	566	218	1,121,943	19,400
Rolm Corp.	1970	292	32	502,642	7,049
Cray Research	1972	58	12	125,008	1,551
Federal Express	1973	6,769	518	1,436,305	18,400
NBI, Inc.	1976	451	55	96,780	1,846
Apple Computer	1977	774	63	982,769	2,050
Digital Switch	1979	0	20	127,052	894
TOTALS		$8,910	918	$4,392,499	51,190

The proposed equity financing vehicle is a modified-for-Ontario version of the SBIC program.

Pro

. forms new pools of capital

. low cost

. accessible

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[11]Source: National Association of Small Business Investment Companies (NASBIC).

- reasonably simple to understand and administer
- accommodates multiple financings, varied corporate structures
- provides a vehicle for channelling institutional funds (pension funds) into growing businesses

Con

- incentive may not be sufficiently attractive
- new to Canada - take-up may be slow

D. Recommended Strategy

The pool program is the recommended strategy. Although investment vehicles which have been successful in the U.S. are not easily imported into the more conservative Canadian capital market, the pool model satisfies the design features and criteria listed above except for the following:

Design Features:

- **Tax treatment of proceeds.** The pool vehicle does not include any special tax treatment for gains on investments in growth firms. The program may be able to piggyback on the federal capital gains exemption for small business shares.

- **Awareness.** The pool program contains no specific awareness strategies. However, opportunities for public awareness of entrepreneurship and venture capital investing will attend the success of portfolio firms.

Design Criteria:

- **Liquidity.** Pool and growth firm investments are relatively illiquid - a disincentive for some investors.

In summary, the pool proposal has the following advantages:

- **Growing firms** qualifying for assistance from the program receive lower-cost equity and management advice.

- **Venture capitalists** can supplement their private investment capital with funds borrowed at favourable rates, and can increase their experience and expertise.

- **Institutional investors** can participate in funding the growth companies sector at acceptable risk levels.

- **Ontario residents** benefit from multiple products and services provided by a vital growth firm environment and from the increased job opportunities such an environment fosters.

- **Taxpayers** save money as the program provides its services extremely cost-effectively. Taxpayers also benefit from increased tax revenues from prosperous businesses and their employees.

IV. PROGRAM ELEMENTS

A. Overview

Privately-owned and -operated pools of capital, regulated by the Government of Ontario, invest in Ontario's growing businesses. The pools provide both capital and participative management expertise to their portfolio companies.

The pools can be organized as corporations or as limited partnerships. They can be held by independent investors, banks, financial organizations, or corporations.

A pool can apply to the Ontario government for a government guarantee of its ten-year debentures for up to twice the amount of its equity to a ceiling of $35 million.

Pools may invest up to 20% of their capital in any single growing business. Each pool must provide equity capital and may provide long-term (5-20 year) loans or purchase debt securities such as convertible debentures.

Pools may not take control positions in their portfolio companies, nor may they charge more on term loans than a prescribed maximum interest rate. In other respects, pools are free to negotiate with each individual business and create the deal that best serves the parties' interests.

B. Regulation

Initially, a pool must raise a minimum of $5 million equity capital from its investors to qualify. Investors who take an equity position of 10% or more in the pool may not use borrowed funds to finance their position.

The Ontario government subjects the pool and its investors to a thorough scrutiny, asking for detailed information on the following:

- the pool's investment policy;
- a detailed plan of operation indicating the types of industries and businesses in which the pool intends to invest;
- the sources of the pool's initial capitalization;
- the locus of responsibility for the pool's management and control;
- a list of the pool's directors and officers.

A regulatory body, with private sector participation, conducts extensive background checks of the applicants and must approve the full-time manager - generally someone with a strong interest in aiding growing businesses and with a number of years of experience or combination of experience and training in business investing.

The regulatory body can set the maximum aggregate amount of salaries and other compensation the pool may pay to its directors, officers and employees.

The applicants (promoters) and the manager must all have an equity stake in the proposed pool.

Pools are subject to annual reporting requirements and to yearly inspection. They also must submit audited financial statements yearly.

C. **Capitalization**

Once the pool has invested 65% of its initial equity in eligible growth firms, it may apply to the Ontario Development Corporation (ODC) for a guarantee of its debentures. The ODC's agreement to guarantee a pool's debentures is discretionary. The ODC looks at the pool's capital adequacy, asset quality, management performance, earnings capability, and liquidity characteristics in deciding whether to approve the guarantee.

A non-refundable fee to cover the administrative costs of processing must accompany the application.

There are several options as to the form and terms of the guaranteed debentures. The options address the pool's ability to pay debenture interest from non-income-producing equity investments.

1) Debentures may be guaranteed in full by the Government of Ontario and bear interest at a rate determined by the Treasurer of Ontario - equal to or slightly higher than the rate for ten-year government bonds. The debentures are attractive to institutional investors because they pay a return on an instrument of equal safety with ten-year treasury bills or government bonds. (This is the favoured method in the United States. Recent U.S. SBIC debenture rates have ranged between 7.95% and 10.35%.)

Under this option, pools would have to allocate their investment dollars so that the percentage in interest-bearing long-term debt would cover the debenture interest payments. This could reduce the ultimate return to the

pool's investors, burden the recipient business with an increased debt:equity ratio, and provide unnecessary competition to the chartered banks.

2) Another option is a deferred-interest debenture, under which interest accrues at the stated rate but is not payable until maturity. Pension funds, who need not rely on an income stream, may find such instruments attractive, and relief from the burden of ongoing interest payments allows the pool to focus on longer-term equity investments.

3) A third option is a participating debenture at a lower interest rate. The principal only would be guaranteed by the Government of Ontario, with no guarantee of interest. The prospect of secure principal plus possible higher returns may prove attractive to investors, while the lower interest rate would assist the pool's cash flows.

The debentures may be marketed individually, or debenture pools may be formed periodically, through a private-sector not-for-profit agent, and participation certificates in the pools sold.

Both debentures and participation certificates in debenture pools are marketed to institutional investors, notably pension funds. The income stream to the debenture-holders can be secured by a prohibition against prepayment during the first five years.

The Ontario Government receives a fee, in consideration of the guarantee, payable out of the proceeds.

The proceeds of a pool debenture issue may be used to retire an earlier outstanding debenture. In this case, however, the guarantee fee must be tendered before the guarantee commitment is made. Guarantee fees are not refundable in the event of prepayment.

If a pool is in serious financial difficulty, the ODC has the power to require it to cease operating. The ODC may appoint a receiver and manager of the pool, who may continue operating it or collapse it at the ODC's direction.

D. **Eligibility Criteria**

1. <u>Pool</u>

Pools may be closely or widely-held, organized as corpora-

tions or as limited partnerships. They may be owned by independent investors, banks, financial organizations, or corporations.

2. Portfolio Company

Portfolio companies must be corporations.

Although the initiative is targetted to all emerging growth-oriented companies, dollar-value cut-off points to determine eligibility have been stipulated to simplify administration of the program. The cut-off points could be included in the regulations for maximum flexibility. Performance-related criteria, focussing on rate of growth, could be used instead of or in addition to the cut-off points.

The following are not qualified investments:

- companies with more than $20 million in annual sales;
- companies with more than 50% of their assets and operations outside Ontario;
- passive or casual businesses not engaged in regular and continuous business operations;
- companies engaged in real estate, financing or mining activities;
- companies connected to the pool, its shareholders, directors, officers, members or employees;
- other pools.

All other businesses are eligible.

Matching services are available through the Canada Opportunities Investment Network (COIN) to assist pools in identifying potential opportunities.

E. Investment Regulations

1. Investments in Growing Businesses

Pools may invest no more than 20% of their capital in any single growing business. The regulatory body may allow a pool to supersede this limit in appropriate cases.

Each pool must provide equity capital to growing businesses. The minimum percentage of total capital which pools must invest in equity may be set by regulation;

otherwise, market forces will govern the allocation.[12]

One option is to increase the multiple of government-guaranteed matching funds in proportion to the percentage of capital invested in the equity shares of growing businesses. For instance, a pool with 65% of capital invested in growth business equities could issue government-guaranteed debentures equal to its private capital. Investing 75% and 85% in equity would allow a pool to borrow, respectively, 1.5 and twice its private capital.

Pools cannot take control positions in portfolio companies unless to do so is necessary to protect the investment. Pools must obtain the regulatory body's approval of the investment and divestiture plan.

Pools can provide long-term (5 to 20 year) loans or finance through convertible debentures. The loans can be secured. Pools can not charge more on term loans than a maximum prescribed interest rate. Short-term (less than five years) loans are permitted only in exceptional circumstances.

In other respects, pools are free to negotiate with each individual business and create the deal that best serves the parties' interests.

2. Other Qualified Investments

Pools can invest temporarily idle funds in short-term instruments like T-bills, GICs and demand bank and trust com-

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[12]U.S. SBICs, without being subject to a minimum equity requirement, have over the past dozen years distributed their investment dollars, on the average, fairly equally between loans, convertible debt and straight equity. The breakdown varies somewhat from year to year, with the straight equity portion ranging from a low of 12% in 1975 to a high of 47.2% in 1983. Convertible debt ranges between 28-35.8%.

58% of SBICs, listing their investment intentions, prefer financings which give them the right to acquire equity shares; a further 33.3% will consider both loans and equity investments. Only 8.6% state a preference for loans.

Source: See Appendices I and II.

pany deposits while awaiting a qualified investment opportunity. Otherwise, pools must maintain the equity investment ratio that qualified them for matching funds.

Another option is to allow pools to place in short-term investments an amount equal to two or three years of debenture interest and invest the remaining funds in quality equity investments with staggered expected maturity dates. In this way, the pool would have funds on hand to meet the interest payments in the initial period. At the end of this period, when the segregated funds were exhausted, an equity investment would be cashed out.

Pools can retain their investments in firms which qualified at the time of financing, but have since outgrown eligibility, so long as it does not interfere with the financing of other growing businesses. However, no additional financing can ordinarily be provided to the outgrown businesses.

F. Securities Regulation

Pool investments, if greater than $150,000, fall within the private placement exemption of the Securities Act (Ontario) and proceed without a prospectus. Resales also fall within this exemption if the $150,000 threshold is met.

Pool promoters must take account of Securities Act provisions and Ontario Securities Commission (OSC) policies. For instance, a pool's full-time manager may be classified as an "investment adviser" under the Securities Act and be required to register. In marketing debentures to institutional investors, a pool may have to register as a "limited market dealer" or ask the OSC for an exemption from registration. Finally, a matching mechanism, if considered a matching service or broker, may be classified as a market intermediary and be required to register as a "limited market dealer" under the Securities Act.

G. Provision of Management Services

Pools are encouraged to provide value added as well as capital to portfolio companies. Pools can give advice or take a more active role regarding a company's financial, management, administrative or operating activity. Pools may be compensated for these services at rates which do not exceed those charged by comparable professional consultants.

H. Special Anti-abuse Provisions

Prohibited uses of funds. Funds may not be used to buy

back outstanding shares of the business unless a change of ownership is being financed or the buy-back is necessary to ensure sound financing.

Without the regulatory body's prior written approval, pools cannot buy back or retire private equity capital or make distributions to investors other than periodic payments out of retained earnings based on the investors' capital contributions.

Arm's length provisions. Debenture investors cannot have more than a 10% interest in the issuing pool, its associates, affiliates or relations.

A change in the pool's control or ownership requires the regulatory body's approval.

Miscellaneous. The portfolio business receives the invested funds directly.

V. COSTS AND BENEFITS

A. Costs

Estimated take-up for the first 12 months of the program is $20 million invested in 15 small and mid-sized firms. By the fifth full year of the program up to $100 million annual new investment is expected.

The Government's ultimate liability for losses on debenture guarantees is estimated to be about 12% of the amount guaranteed. Annual administration costs are estimated at $1 million.

In the following tables, the 40% option represents the historical amount of average leverage in the U.S. SBIC program. The 66 2/3% option represents total allowable leverage on a 2:1 matching basis.

ESTIMATED TAKE-UP

Year	No. of Businesses Invested In	Amount Invested	Amount Guaranteed by Government @ 40%	Amount Guaranteed by Government @ 66 2/3%	Loan Loss Over 10 years @12% @ 40%	Loan Loss Over 10 years @12% @ 66 2/3%	Admin. Cost
		$ millions					
1	15	20	8	13	.9	1.6	1.0
2	20	30	12	20	1.4	2.4	1.0
3	30	50	20	33	2.4	4.0	1.0
4	45	75	30	50	3.6	6.0	1.0
5	75	100	40	67	4.8	8.0	1.0
6	100	135	54	90	6.5	10.8	1.0

ESTIMATED COST PER JOB

Year	Jobs Created Over 10 Years	Total Cost to Govt. @ 40%	Total Cost to Govt. @ 66 2/3%	Cost per Job @ 40%	Cost per Job @ 66 2/3%
		($ millions)		($)	
1	1,050	1.9	2.6	1,810	2,476
2	1,400	2.4	3.4	1,714	2,428
3	2,100	3.4	5.0	1,619	2,381
4	3,150	4.6	7.0	1,460	2,222
5	5,250	5.8	9.0	1,105	1,714
6	7,000	7.5	11.8	1,071	1,686

B. **Benefits**

Once the program is well-established (estimated five years from launch), an individual pool would manage perhaps $30 million in assets, divided amongst about 18 growth-oriented businesses in the following proportion:

- 8 firms in the $350,000 - $1 million investment range;
- 6 firms in the $1 - $2 million investment range;
- 4 firms in the $2 - $5 million investment range.

A number of benefits are expected to stem from the program:

. More small and young companies will be able to realize their growth potential.

. Thousands of new jobs will be created.

. The economy will be strengthened and better positioned to ride out cyclical downturns.

. Government revenues from income and commodity taxes will increase.

. Institutional funds, previously unavailable to small and mid-sized firms, will be accessed.

. A strengthened venture capital industry will be available to service the financing needs of dynamic businesses.

. A financial infrastructure, ready to compete in the post-free trade investment market, will be in place.

APPENDIX I

U.S. SBIC INVESTMENT PREFERENCES
Percentage of SBICs Choosing Each Option

	%
Preferred limit for financings:	
≤$100,000	16.3
≤$250,000	27.2
≤$500,000	21.1
≤$1 million	20.7
>$1 million	14.6
Investment policy:	
Right to acquire stock preferred	58.0
Loans or equity considered	33.3
Long-term loans preferred	8.6

U.S. SBIC INVESTMENT PREFERENCES
Percentage of Total Responses Indicated by SBICs

	%
Industry preferences:	
Diversified	23.7
Manufacturing and Processing	14.6
Medical and Health Services	12.6
Communications	12.4
Research and Technology	9.4
Retailing, Wholesaling & Distribution	9.2
Services	5.2
Transportation	4.3
Hotels, Motels and Restaurants	2.5
Construction & Real Estate Development	2.5
Natural Resources	2.2
Recreation and Amusements	1.4

N.B. SBICs could indicate more than one area of preference.

Source: Compiled by the Small Business Branch, Ministry of Industry, Trade & Technology from the **1986-87 NASBIC Membership Directory**. The Directory lists 323 SBICs representing approximately 90% of licensed SBICs.

APPENDIX II

HISTORY OF U.S. SBIC FINANCINGS

Percentage of total dollars flowed by type of financing

Year ending: (total $ value)	Debt	Debt with Equity	Equity only	Total
		%		
December 31, 1975 ($122.7 million)	52.3	35.8	11.9	100.0
December 31, 1980 ($295.2 million)	34.3	35.4	30.3	100.0
December 31, 1981 ($332.7 million)	32.8	31.7	35.5	100.0
December 31, 1982 ($332.9 million)	27.8	30.0	42.2	100.0
December 31, 1983 ($412.9 million)	24.4	28.4	47.2	100.0
December 31, 1984 ($425.5 million)	25.6	31.5	42.9	100.0
December 31, 1985 ($434.6 million)	27.6	31.7	40.7	100.0
December 31, 1986 ($475.9 million)	33.2	32.3	34.5	100.0
December 31, 1987 ($537.9 million)	36.7	29.7	33.6	100.0

Source: Compiled by the Small Business Branch, Ministry of Industry, Trade & Technology from information received from the Office of Investment, U.S. Small Business Administration.

APPENDIX III

U.S. SBIC ACTIVITY

The average U.S. SBIC has $4.4 million in total private capital.

In fiscal year 1987 (October 1, 1986 - September 30, 1987), 317 SBICs with total capital resources of $2.41 billion (average $7.6 million) held licenses. These SBICs arranged 2,547 financings for a total of $553.5 million in fiscal 1987. Each quarter on the average, about 160 SBICs provided financing to approximately 490 small businesses.

During calendar year 1987, 1,677 small businesses received 2,522 financings totalling $537.9 million. These small businesses had the following characteristics:

	AVERAGE	MEDIAN
Employment	49	16
Revenues	$2.4 million	$849,000
Assets	$2.4 million	$895,000

The following data covers calendar year 1987:

Funds flowed to SBIC portfolio firms, by age of firm:

	%
<3 years old	57.4
3-6 years old	17.1
6-10 years old	9.8
>10 years old	15.6

Funds flowed to SBIC portfolio firms, by type of firm:

	%
Corporations	86.4
Proprietorships	4.7
Partnerships	8.9

Funds flowed to SBIC portfolio firms, by sector:

	%
Manufacturing	35.6
Transportation, Communications & Utilities	18.3
Service	15.8
Retail	13.8
Construction	6.8
Financial, Insurance & Real Estate	4.3
Wholesale	4.3
Other	1.1

Source: U.S. Small Business Administration, SBIC Digest, April and October 1987.

APPENDIX IV

RECENT SBIC DEBENTURE ACTIVITY

As of September 1, 1987, there were 318 SBIC licensees in operation with over $1.4 billion in private capital. Of these SBICs, 116 had no outstanding debenture borrowings guaranteed by the U.S. Small Business Administration (SBA). The remaining 202, with aggregate private capital of approximately $862 million, had outstanding SBA-guaranteed debenture borrowings of $902 million.

The following are details of participation certificate offerings:

DATE OF OFFERING	AMOUNT RAISED (millions)	INTEREST RATE
September 24, 1986	$67.2	8.75%
February 4, 1987	$49.2	7.95%
April 27, 1987	$18.0	8.95%
September 23, 1987	$84.2	10.35%
February 10, 1988	$19.6	8.85%

SBA anticipates continuing quarterly offerings of participation certificates in SBIC debenture pools.

Source: Offering Circular for U.S. Small Business Administration Guaranteed Participation Certificates, dated September 23, 1987; U.S. SBA **SBIC Digest**, April 1988.

APPENDIX V

U.S. SBIC PROGRAM LOAN LOSS RATE AND COSTS
(as of September 30, 1986)

Actual losses

Loans charged off as losses	$ 58,379,751
Less: recoveries	(19,021,233)
Net losses	$ 39,358,518

Projected losses from active portfolio

Funding outstanding	$1,239,801,131
Estimated default rate	25%*
Gross loans estimated to default	$ 309,950,283
Estimated loss rate	43.1%**
Projected losses from active portfolio	$ 133,588,572

*The estimated default rate is based on the historical default rate range of between 20% and 30%.

**The estimated loss rate is arrived at by a case-by-case examination of all outstanding SBICs.

Ultimate losses

Actual net losses	$ 39,358,518
Allowance for losses in liquidation	130,267,343
Projected losses from active portfolio	133,588,572
Total actual and estimated losses	$ 303,214,433

The ultimate loss rate is 12.0% (total actual and estimated losses of $303,214,433 divided by $2,517,488,617 in total disbursements).

Administration costs

Annual salaries and benefits	$1.2 million
Annual indirect costs (rent, legal & accounting fees)	$1.2 million
Total annual administration costs	**$2.4 million**

Source: SBA data as of September 30th, 1986 (most recent available data) as compiled by the Small Business Branch, Ministry of Industry, Trade & Technology. All figures are in $U.S.

APPENDIX VI

CANADIAN VENTURE CAPITAL ACTIVITY IN SMALL FIRMS

Canadian venture capital investment in smaller firms has been decreasing both in absolute and in relative terms, even though the overall number of investments and value of investment dollars has increased.

Investments by Venture Capitalists in Companies with Gross Revenues up to $4 million, Canada, 1985 and 1986

	1985		1986	
	#	%	#	%
Investee Companies	68	53	44	35
Investments	86	52	60	34
	$(millions)	%	$(millions)	%
Value	$34.4	24	$28.3	18

Total Number of Investments and of Investment Dollars Invested by Venture Capitalists in All Companies, Canada, 1985 and 1986

	1985	1986
Number of Investments	166	179
Value (millions)	$141.5	$158.4

Source: Thorne Ernst & Whinney and Venture Economics Canada Limited, Association of Canadian Venture Capital Companies: Unaudited Information (May 1987).